

ADDRESS OF
A. F. FALLS, F. C. A.
CHATHAM, ONT.
DELIVERED AT
LONDON, ONT.



WESTERN COUNTRIES TELEPHONE ASSOCIATION
JULY 4TH, 1918

TELEPHONE ACCOUNTING AND THE BALANCE SHEET

Your Secretary invited me to address you today and with the invitation enclosed statements for the year ending Dec. 31st, 1916, which had been presented to the shareholders of a company owning and operating a telephone system in Ontario, with the suggestion that I might use it for the purpose of this address.

As I had not audited the books nor was familiar with the conduct of the affairs of the Company it was advisable to write and ask questions so that I would be seized of facts not contained in the statements in order that I might discuss the subject more intelligently.

The statements as presented to the shareholders of the Company for the year ending Dec. 31st, 1916, furnished me are as follows:—

REVENUE ACCOUNT

RECEIPTS		EXPENSES.	
To		By	
Balance, Dec. 31st, 1915	\$1317 19	Salaries—Operating	
Rentals	5540 90	Switchboards	\$2147 00
Telephones (Sold)	273 00	Salaries, Head Office	426 00
Earnings from Connecting Companies	1847 94	Directors' Fees	25 70
Moving and Installing	59 25	Printing, Stationery and Postage	118 55
Sales	46 70	Freight and Express	24 88
Sundries	51 75	Material	331 34
Interest	108 39	Telephones	185 03
		Batteries	385 15
		Taxes	31 52
		Rebate, Rental	2 25
		Connecting Toll Companies	403 38
		Rent	12 00
		Labor	1038 24
		Sundries	108 44
		Dividends	651 30
		Carried to Construction Acct.	138 28
		Carried to Depreciation Acct.	664 68
		Carried to Reserve Fund	500 00
		Balance	2051 38
	<u>\$9245 12</u>		<u>\$9245 12</u>

CONSTRUCTION ACCOUNT

RECEIPTS.		DISBURSEMENTS	
To		By	
From Revenue Account	\$ 138 28	Labor	\$ 37 25
		Poles	26 09
		Wire	50 00
		Supplies	25 03
	<u>\$ 138 28</u>		<u>\$ 138 28</u>

DEPRECIATION ACCOUNT

RECEIPTS.		DISBURSEMENTS	
To		By	
Balance, Dec. 31st, 1915	\$ 96 49	Labor	\$ 24 95
From Revenue Account	664 68	Poles	17 50
		Supplies	79 20
		Balance	639 52
	<u>\$ 761 17</u>		<u>\$ 761 17</u>

RESERVE FUND

RECEIPTS.		DISBURSEMENTS	
To		By	
Balance, Dec. 31st, 1915	\$1100 00	Balance	\$1600 00
From Revenue Account	500 00		
	<u>\$1600 00</u>		<u>\$1600 00</u>

BALANCE SHEET

	Assets.	Liabilities.
Buildings and Real Estate	\$ 700 00	
Central Office Equipment	500 00	
Tools	50 00	
Office Furniture and Fittings	15 00	
Pole, Wire and Cable Equipment	12028 62	
	<u>\$13293 62</u>	
Less 5% Depreciation	664 68	
	<u>\$12628 94</u>	
Stock on Hand	250 00	
Accounts Receivable	7 00	
Profit and Loss	2304 96	
Stock Paid Up		\$10900 00
Unclaimed Dividend		20 40
Dividend No. 13—Due Dec. 30th, 1916.		654 00
Depreciation Reserve		639 52
Reserve Fund		1600 00
Net Surplus		1376 98
	<u>\$15190 90</u>	<u>\$15190 90</u>

It will be seen that the statement under review is divided under the headings:—

REVENUE ACCOUNT

CONSTRUCTION ACCOUNT

DEPRECIATION ACCOUNT

RESERVE FUND

BALANCE SHEET

Any one of these headings represents a subject broad enough to occupy the entire time allotted for an address at such a gathering as this.

It is my intention to take up each one of these headings as briefly as possible to touch on the salient points of each and convey as much useful information as time will permit.

Before doing so I desire to state the important points brought out by the questions asked and answers received which throws further light on the workings of the Company under review.

REVENUE

(a) To the revenue account is charged new telephones, supplies, material, etc., used in repairs, also work performed, the payment of which is credited revenue account.

(b) Interest credited revenue account is the interest received on the reserve and other funds of the company from the bank.

(c) Dividends—\$651.30 is amount paid in 1916 on dividend No. 12, due Dec. 30th, 1915.

(d) The BALANCES shown in the respective accounts as of Dec. 31st, 1915, and the balances at the end of the year Dec. 31st, 1916, are actual cash balances in the bank at that time.

CONSTRUCTION.

(e) Expenditures under this head cover extension of plant for installing new subscribers. Material originally charged to construction account.

BALANCE SHEET

(g) There is no loss, and to the question was there no cash on hand or in the bank? the reply was: There is an actual cash balance on hand and in the bank made up as follows:—

Balance in Reserve Account	\$2051 38
Balance in Depreciation Account	639 52
Balance in Reserve Account	1600 00
	<hr/>
	\$4290 90

which is shown in the balance sheet only among the liabilities as:—

Unclaimed Dividends	\$ 20 40
Dividend No. 13, due Dec. 30, 1916	654 00
Net Surplus	1376 98
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	\$2051 38

Depreciation Reserve	639 52
Reserve Fund	1600 00

\$4290 90

(h) All subscribers' rents of phones were paid up to Dec. 31st, 1916, except \$7.00, which is included in the Assets as Accounts Receivable.

(i) The stock on hand, \$250.00, belongs to the Revenue Account.

(j) All liabilities were paid. The collecting toll line settlements are made every three months, the last quarter to which settlements were made ended Nov. 30th, 1916. Wages of operators, etc., were all paid before Christmas for the month of December.

REVENUE ACCOUNT

The Revenue Account is frequently called Profit and Loss Account, and treated by many as if they were the same.

The Revenue Account in a concern conducted for profit, properly covers the revenue for the year or such other period covered by the statements presented, distinct from the results of any other period. It embraces all accounts dealing with income, earnings or profit against which appear the cost, expenses and losses connected therewith. The net profit or loss for the period as shown by the revenue account should be transferred to the Profit and Loss account and then disposed of in such manner as the Directors may deem in the best interests of the shareholders.

The Revenue Account under review includes the cash balance of the previous year brought forward and omitted the inventory of stock on hand Dec. 31st, 1916, although the amount is included as an asset in the balance sheet.

It would have been very much clearer to the shareholders if the result of the year ending Dec. 31st, 1916, was separated from the balance of the previous year and the other items for reserve, dividend, etc.

To illustrate what I have said and make it quite clear to everyone what is meant, separate Revenue and Profit and Loss statements have been prepared. The only item included here that is not in the revenue account under revenue is \$250.00 of material on hand, paid for out of revenue account which is included in the balance sheet, and for the purpose of ascertaining the result must be included as an inventory placed to the credit of Revenue Account. These statements are as follows:—

REVENUE ACCOUNT

For The Year Ending Dec. 31, 1916.

By Rentals		\$5540 90
By Telephones (sold)		273 00
By Earnings from Connecting Lines		1847 94
By Moving and Installing		59 25
By Sales		46 70
By Sundries		51 75
By Interest on Bank Accounts		108 39
By Inventory		250 00
To Salaries, Operating Switchboard	\$2147 00	
To Salaries, Head Office	426 00	
To Directors' Fees	25 70	
To Ptg., Postage and Stationery	118 55	
To Freight and Express	24 88	
To Material	331 34	
To Telephones	185 03	
To Batteries	385 15	
To Taxes	31 52	
To Rebate Rental	2 25	
To Connecting Toll Companies	403 38	
To Rent	12 00	
To Labor	1038 24	
To Sundries	108 44	
To 5% Depreciation	664 68	
Revenue for year carried to Profit and Loss.	2273 77	
		<hr/>
	\$81177 93	\$8177 93

PROFIT AND LOSS

By Balance Dec. 31, 1915		\$1317 19
By Profit from Revenue Acct. Dec. 31, 1916		2273 77
To Dividends to Dec. 13, 1915	\$ 651 30	
To Construction Account	138 28	
To Reserve	500 00	
To Balance at Credit of Profit and Loss ...	2301 38	
		<hr/>
	\$3590 96	\$3590 96

It will be seen from the foregoing statements that the Revenue for the year ending Dec. 31st, 1916, was \$2273.77, according to the statements and information placed at my disposal. Depreciation of 5% has been taken into account in arriving at the above figures.

The balance from Dec. 31, 1915, \$1317.19, appears in the Profit and Loss account to which is added the revenue for 1916. The charges to Profit and Loss account will be referred to later under the different heads to which they belong.

CONSTRUCTION ACCOUNT

It is shown that \$138.28 has been disbursed for labor, poles and wire, information furnished on this point is:—"Extension of plant for installing new subscribers, material originally charged to construction account." If that is the case why is there a charge for material which has already been charged Construction Account? Why is \$138.28 not charged to Construction Account instead of Revenue Account? Any expenditures on construction should not be a charge of the operating account for the period but should be an additional expenditure on Capital account and included in the fixed Assets.

DEPRECIATION ACCOUNT

Depreciation is a charge on revenue account. The object of writing off depreciation from the sum at which assets appear in one balance sheet is to make allowance for any diminished value so that these assets may appear in each Balance Sheet at their true value.

The subject of Depreciation is a very broad one, different classes of assets depreciate at different rates. No one rate could be fixed that would apply fairly to all the different materials that enter into the construction of a telephone system. It would not be correct to say that telephones, batteries, poles, wire, etc., all depreciated the same percentage of the cost.

Provision for depreciation is usually made by charging up to Profit and Loss annually an amount as reserve for depreciation and placing the same to the credit of a Depreciation Reserve Account. Renewals and replacements are a proper charge to revenue account in the period when any portion of what has properly been charged to Construction Account is renewed. This would apply except in the case of the reconstruction of capital investments that have become incapable of performing the functions for which originally constructed.

In such exceptional cases of that kind the reserve is called on to place the capital investment in an efficient condition to continue to do what the original investment was expended for.

In the case of the Company under review the depreciation account has not been treated as a Reserve, but more in the nature of an account with appropriations from the Revenue or Profit and Loss account each year, part of which has been used to buy supplies and material as well as pay for labor for replacement of poles and lines which had to be repaired or replaced. The manner in which the depreciation account is treated it might be more properly called Renewal and Replacement Reserve.

RESERVE FUND

A Reserve is an amount set aside out of profits or other credit balances not representing a liability to creditors.

The Reserve Fund of the company under review is a proper reserve fund in every sense of the word and complies with the strictest interpretation of what a reserve fund should consist because it is represented by cash in the bank.

There is a great deal of difference of opinion in regard to the manner in which amounts set aside as reserve fund should be invested. In Insurance, Trust Companies, Banks, etc., it is invested in securities, but in manufacturing concerns, where the demand for extension of the business, enlargement of the plant, and the carrying of large stocks of raw and finished material, is necessary for the proper conduct of the business, the reserve fund is invested in the general assets of the Company and not specially ear-marked as Reserve. Many companies that invest their reserve or part of it in securities have purchased Victory Bonds, which is not only good business but is also patriotic as well.

The Revenue or Profit and Loss Account was charged on Dec. 31st, 1916, with \$500.00, which increased the Reserve from \$1100.00 to \$1600.00.

BALANCE SHEET

On examining the balance sheet under review the principal items that attract attention are the following:—

(a) That 5% depreciation is deducted from the fixed assets, \$664.68, and is again shown in the Depreciation Reserve account as a liability for the amount of \$639.52.

(b) That no cash on hand or in the bank appears among the Assets.

(c) That there is a profit and Loss balance of \$2304.96 shown among the Assets. This cannot mean anything else but a loss, which is absurd in view of the fact that there is a surplus shown and also reserves.

(d) That there is a surplus of \$1376.08, also depreciation reserve of \$639.52, and reserve fund of \$1600.00.

(e) The manner in which the balance sheet is drawn up distinctly shows that the affairs of the company are not kept by double book-keeping, and the ledger balance when statements are made out.

CRITICISM OF BALANCE SHEET

I Will Now Take Up These Different Points in Order.

(a) The amount of \$664.68 deducted from the fixed assets was charged to Revenue Account and credited to Depreciation Account; part of this was expended, the balance remaining Dec. 31st, 1916, \$639.52 appears in the balance sheet so that the \$664.68 appears twice in the balance sheet. It never should have been deducted from the fixed assets in the balance sheet.

(a) As already stated I am informed that there was actually \$4290.90 of cash on hand or in the bank Dec. 31st, 1916, which should

have appeared in the assets in the balance sheet as follows:—

Cash in Revenue Account	\$2051 38
Cash in Depreciation Account	639 52
Cash in Reserve Account	1600 00
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	\$4290 90

(c) The amount of \$2304.96 Profit and Loss included in the balance sheet among the Assets means a loss the way it is shown; this amount appears to have been arrived at by entering as Liabilities the capital paid up \$10,900.00, and cash on hand divided in five items \$4290.00, making a total \$15,190.90, and deducting from this amount the total amount of the fixed assets after deducting 5% and adding to it the material on hand, \$250.00, and \$7.00 accounts receivable, making a total of \$12,885.94, the difference of \$2304.96 must appear in the statement or it would not balance, so it is inserted under the heading Profit and Loss.

(d) The surplus shown as a liability is arrived at by deducting from \$2051.38 the balance shown on December 31st, 1916, to be in the bank at the credit of Revenue, the amount of \$674.40 made up of unclaimed dividends, \$20.40, and \$654.00 as dividend No. 13, due Dec. 31st, 1916. There is nothing in the statement to disclose the fact that the dividend had been declared, the revenue account has not been charged and unpaid dividend account credited with this amount which is the usual procedure.

(e) If the books of the company were kept by double entry the ledger balance could not possibly agree with the balance sheet as presented, and the omission of cash balances, etc., would never have occurred.

REVISED BALANCE SHEET

In accordance with what has been stated in connection with the balance sheet and in order to make clearer the balance sheet as it should be according to the information at hand, I have prepared a revised balance sheet as follows:—

BALANCE SHEET, Dec. 31st, 1916.

ASSETS

Fixed Assets—

Building and Real Estate	\$ 700 00	
Central Office Equipment	500 00	
Tools	50 00	
Office Furniture and Fittings	15 00	
Poles, Wire and Cable Equipment	12028 62	\$13293 62

Available Assets—

Cash in Revenue Account	\$ 2051 38	
Cash in Depreciation Account	639 52	
Cash in Reserve Account	1600 00	
Material on hand	250 00	
Accounts Receivable	7 00	\$ 4547 90
		<hr/>
		\$17841 52

LIABILITIES

To Shareholders—

Capital Paid Up	\$10900 00	
Dividend Unclaimed	20 40	
Dividend No. 13, due Dec. 30, 1916	654 00	
Depreciation Reserve	639 52	
Reserve Fund	1600 00	
Profit and Loss	2301 38	
Surplus	1726 22	\$17841 52

In the revised balance sheet there is a surplus of \$1726.22 over and above the Profit and Loss of \$2301.38 and after providing \$654.00 for dividend No. 13, Dec. 31, 1916.

REVENUE OR PROFIT AND LOSS

In the affairs of any Company it is very desirable that the result of the operations be presented to the shareholders so that the ordinary shareholder can tell what the actual result of the year's operations are, without the necessity of asking an experienced bookkeeper or expert accountant to find out by the analysis of accounts what the profits amount to.

The importance of simplifying statements cannot be too strongly impressed upon those whose duty it is to prepare statements to be submitted to shareholders.

Statements of profits cannot be made too simple and should be framed so the results can be seen at a glance.

CONSTRUCTION.

To construction account should be charged any material or labor that does not replace something that has already been charged to construction account. There are exceptions to this; for instance, if an ordinary line was replaced by heavy copper wire under such circumstances it is considered proper to charge to construction account the difference in price of the wire.

DEPRECIATION

Depreciation Account is a reserve set aside out of profits annually for the purpose of creating a fund to replace fixed assets when their usefulness becomes exhausted. It should not be charged with repairs and renewals as they are a proper charge against the operating expenses of a company during the period in which they are renewed.

RESERVE.

Reserves are set aside to meet future contingencies that may arise. In a company such as the one under review it would be wise to invest the reserve in sound securities that would yield them a better rate of interest than is paid on savings bank accounts.

BALANCE SHEET

A leading Scotch Chartered Accountant, who is an authority on accounting, gives the following definition of a balance sheet:—

"A Balance sheet is a concise statement compiled from the books of a concern which have been kept by double entry, showing on the one side all the Liabilities and on the other side all the Assets of the concern at a particular moment of time."

CONCLUSION.

I had hoped to have been able to take up some other phases of accounting but find that I have exhausted the time at my disposal.

It is a pleasure to me to come and be with you today and I hope that my efforts express to you in as simple a manner as possible, some of the important points in the properly preparing of a balance sheet.